Lebanon's Economic Prospects and Challenges[1]
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Lebanon, a small middle-income country with a tragic modern history, is now trying to rebuild, politically and economically, while simultaneously weathering the global and regional recession. Strife among the 18 separate religious sects that comprise Lebanese society (and whose leaders have frequently commanded more loyalty than the national government), violent intervention by neighboring Syria, and Lebanon's entanglement in broader regional conflicts have repeatedly torn apart this country of only 4.1 million people and caused extensive damage and suffering in the past and are still threats today.

In return for pledges of aid, the government committed itself to a program of reforms at the Paris III Conference of January 2007, but delivering on those promises has proved to be difficult. The major elements in the reform program were fiscal consolidation, debt reduction, privatization of two mobile phone companies, and increases in electricity tariffs to eliminate or at least ameliorate costly subsidies. Implementation of the reform program stalemated under the "national unity" government formed in July 2008, but the peaceful election of June 2009, which was won by the "March 14" coalition, has brought renewed hope for renewed reform efforts and continued economic growth. Moves toward heightened dialogue and potential reconciliation in the broader region also bode well for Lebanon's future. But many complications remain to be surmounted: contention over the position in the political system of each of the sects represented in the ruling coalition: relations with Syria; the role of Hizbullah; and the ever-present danger that tensions in the region will erupt once more.

Despite the lack of reform, the economy grew at a record rate of 8% in 2008 and continues to grow in 2009, although at a much slower pace. Even though its financial system, exports, tourism, and remittance receipts are vulnerable to global recession, Lebanon has so far weathered the storm. In 2008, it succeeded in maintaining financial stability, raising international reserves, and reducing public debt. Despite having more linkages to global markets than other banking systems in the region, the Lebanese banking system has not come under stress. The Economist Intelligence Unit (EIU) forecasts economic grow at 2.4% this year (vs. a 4% prediction by the IMF), similar to other countries in the region. The global slowdown is expected to weaken growth in the important real estate, construction, and financial sectors. Investment is likely to be slow as both international and domestic issues keep investors cautious. Some growth in exports is likely, especially to Gulf States. Imports will grow rapidly in volume terms, but declining prices (particularly of petroleum) will dampen growth in the value of imports.

The EIU anticipates a modest recovery in the growth rate for 2010, perhaps to 3.3%, as regional growth and investment begin to recover. However, the possibility that a sudden political crisis could derail the economy is always present. Remittances are an important source of income for many Lebanese households, and an expected drop in their value as Lebanese

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expatriates lose jobs in the Persian Gulf and return home is likely to slow consumption growth in 2008 and 2009.

Lebanon's large current-account deficit, which has averaged 13% of GDP over the past decade, will persist. The trade deficit is estimated at $11.2 billion for 2008 but should narrow slightly in 2009 and 2010 because of lower oil and food prices. However, service exports and transfer receipts, which have helped to finance the deficit in the past, could decline. The net result predicted by EIU is a rise in the current account deficit to perhaps 12.8% of GDP in 2009 and 2010.

Whether the June election will boost investment and tourism remains to be seen. It has been hoped that the peaceful conclusion of the election would raise inward investment and tourism. Tourist arrivals have indeed risen sharply so far this year. Part of the increase, is the return of some 19,000 Lebanese expatriates to vote in the election. However, there is also hope that peaceful conditions in Lebanon, together with recession-induced belt-tightening, will induce more vacationers from Saudi Arabia and the Gulf States to spend their holidays in Lebanon, rather than flying to Europe or the United States. The development of tourism in recent years has been geared toward high-end tourists from the Gulf States and there is some concern about the lack of facilities for budget tourists in a time of economic slowdown.

Fiscal reform is still needed to reduce the large government debt and high debt service obligations. Lebanon's staggering national debt (currently $47.2 billion and 162% of GDP, one of the highest ratios in the world) leaves little scope for countercyclical action. The draft budget drawn up before the June election provides for moderate loosening and is expected to add $4 billion to the national debt. The largest elements of expenditure are debt service, salaries, and electricity subsidies (which alone will add $1.4 billion to the debt). Increased spending on wages and salaries is likely to absorb the fiscal space created by the drop in international oil prices and the reintroduction of the gasoline excise earlier this year. As in the past, it should be possible to finance the budget deficit through Eurobond sales unless the financial environment worsens. In April, Moody's Investors' Service upgraded Lebanon's sovereign debt rating to B2, still a relatively low rating. Moody's cited a substantial improvement in external liquidity, resistance of the public finances to shocks, and the ability of the financial system to finance fiscal deficits as grounds for its ratings upgrade. The Lebanese pound remains pegged to the U.S. dollar, providing an anchor of financial stability that is defended through monetary policy.

Political interests have blocked privatization plans. Subsidies to Electricite du Liban (EdL), the inefficient state-owned electricity monopoly, weigh heavily on the government budget and were equivalent to 5.2% of GDP in 2008. Possible privatization of EdL, two mobile phone companies, and other telecommunications operations has been discussed for some time now. Privatization would bring in immediate government revenue and a liberalized telecommunications sector could generate significant additional fiscal resources in the future. Other possibilities for privatization include the Bank du Liban's non-financial assets, including shares in the national airline and a holding company that owns Casino du Liban. The failure to move on any of these privatization projects shows how controversial such moves are in Lebanon. One important impediment is said to be the interests of important politicians in keeping the companies in the public sector.

Little economic policy making has taken place in recent weeks as all factions have been preoccupied with the election and formation of the government. Public expenditure data for the first quarter of 2009 indicate that budget funds are being disbursed rapidly. Some of this expenditure may have been election-related, but it is clear that subsidy payments to EdL rose sharply. Government revenues are also rose, particularly from customs duties and VAT, but the already large budget deficit almost doubled compared to the same period in 2008. The new government thus faces a worsening fiscal deficit that will put pressure on it to deal with the long-standing issues of privatization and fiscal consolidation and perhaps tax the large measure of local and international goodwill that it currently enjoys. While new government is seen as generally pro-business, progress on privatization is likely to continue to be retarded by the political interest of some of its members in EdL and other public enterprises, as well as by general disagreement about the desirability of privatization.

Unemployment is high and may be pushed higher by returning overseas workers. The unemployment rate was estimated at 9.2% in 2007. Many educated and skilled young people have emigrated in the past to find employment, particularly to the Persian Gulf. Lebanon's growing youth population is both a potential asset and a threat to its economic development and political stability. A lack of job opportunities and limited facilities for job-related education and training could cause the young to turn to extremism.

Reforms are needed to improve the enabling environment for private business. Lebanon ranked 99th among 181 countries on the ease of doing business scale of the World Bank's *Doing Business in 2009.* This ranking is similar to those of Yemen and Jordan and a bit better than those of Egypt and Morocco. One bright spot of Lebanon's business environment is that corporate and personal taxes are low by international standards. (The corporate tax rate is 27% and the top personal income tax rate is only 20%, although some tax is levied even on low wage earners; Lebanon also has a value added tax, but at 10% the rate is lower than in most neighboring countries.) Lebanon ranks relatively high in tax collections and the ease of employing workers but relatively low on enforcing contracts, closing a business, and dealing with construction permits. Obtaining a construction permit was found by the World Bank to involve 20 separate procedures, take 211 days on average, and cost more than twice per capita income. Enforcing contracts and closing a business required even larger numbers of procedures.

Lebanon has received, and continues to receive, strong support from the World Bank, the IMF, the U.S. Government, and other donors. The success of the government's reform program hinges on continued donor support. However, disbursement of foreign aid pledged at the Paris III conference of January 2007 was slowed in 2007 and 2008 by political and security concerns, lack of progress on promised reforms, and, most recently, global liquidity constraints. USAID has operated in Lebanon since 1951. In 2005-2009, USAID's strategy emphasized reconstruction and humanitarian assistance following the Syrian occupation and destruction during the 2006 war with Israel. Objectives of that strategy included strengthening civil society and governing institutions and promoting dialogue among the various social groupings. USAID's new strategy for 2009-2013 will continue that work and also emphasize job creation and income generation, improvements in basic and higher education, improved water management, and infrastructure construction. The World Bank, meanwhile, has a country assistance strategy made up of three pillars: governance for economic management and growth support; development of human capital and the mitigation of the poverty effects of transition; and resource and environmental management. The IMF closely tracks developments in Lebanon, provides short-term financial assistance credits as needed, and advises on fiscal and monetary policy as well as other matters.

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